ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author:	Haynes	Analyst:	Roger Lackey	Bill Number:	SB 1300
Related Bills:	See Legislative History	Telephone:	845-3627	Introduced Date:	01-18-2002
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: 2002 California New Markets Venture Capital Program Act/California Neighborhood Initiative

SUMMARY

This bill would:

- Create two credits in support of neighborhood economic stimulus programs:

  1. One credit would encourage investments in qualified low-income community businesses.
  2. The other credit would encourage contributions to a nonprofit housing or community development organization.

- Provide legislative intent to establish a revitalization tax deduction for rehabilitating and revitalizing buildings in a renewal community in conformity with proposed federal legislation.

- Establish the California New Markets Venture Capital Program and the California Neighborhood Initiative. The Program and the Initiative do not impact the department or its administration of the income tax laws, and therefore, will not be discussed in this analysis.

Each of the credits will be discussed separately in the **"ECONOMIC IMPACT"** and "**ANALYSIS**" sections below.

PURPOSE OF THE BILL

It appears the purpose of the bill is to encourage businesses to invest in low-income communities and housing, and to enact a state tax credit that closely conforms to the federal New Markets Tax Credit.

EFFECTIVE/OPERATIVE DATE

This bill would be effective January 1, 2003. However, the tax credits would apply to taxable years beginning on or after January 1, 2002.

POSITION

Pending.

Board Position:			Department Director	Date
_______ S	_______ NA	_______ NP		
_______ SA	_______ O	_______ NAR	Alan Hunter for GHG	3/13/02
_______ N	_______ OUA	___X___ PENDING		

Summary of Suggested Amendments

Technical amendments are necessary and are provided. In addition, substantive amendments are necessary to resolve implementation and policy concerns. Department personnel are available to work with the author to resolve these concerns and any other issues that arise as the bill moves through the legislative process.

LEGISLATIVE HISTORY

AB 1591 (Leslie, 2001/2002) and SB 1084 (Haynes, 2001/2002) were identical to each other and would allow a credit for investments made in a qualified community development entity. Both bills failed to pass out of their respective Revenue and Taxation Committees.

SB 981 (Haynes, 2001/2002) and SB 553 (Vincent, 2001/2002) were identical to each other and would allow a credit for the donation of cash or real property to a non-profit corporation whose primary purpose is to provide affordable housing for certain individuals. Both bills failed to pass out of their respective Revenue and Taxation Committees.

OTHER STATES' INFORMATION

*Florida, Illinois, Massachusetts, Michigan, Minnesota***,** and *New York* do not allow a credit for investments made in a qualified community development entity. However, those states do provide either enterprise zone tax incentives in economically depressed areas or financial incentives (i.e., industrial development bonds, infrastructure loans and grants, venture capital funds, and other community development assistance programs) to promote community development.

The laws in these states do not allow a credit for the donation of cash or real property to a non-profit corporation whose primary purpose is to provide affordable housing.

These states were examined due to similarities between these states and California's population and business activity.

FISCAL IMPACT

Once the implementation concerns are addressed, this bill would not significantly impact departmental costs.

ECONOMIC IMPACT

1. Investment in Qualified Community Development Entity (CDE) Credit

<u>Revenue Estimate</u>

The proposed tax credit at the state level is linked to federal allocations from the U.S. Treasury that, as of this analysis, have not been made. Therefore, revenue losses due to the proposed credit are speculative. As possible orders of magnitude, based on prorating federal estimates, revenue losses could be on the order of $1 million beginning in 2002-03, growing to perhaps $5 million by 2003-04. This portion of the bill is based on the analysis of SB 1084 from 2001-02.

This bill would require that a qualified CDE be a "domestic" corporation or partnership. Under California Corporations Code Section 167, a domestic corporation means a corporation formed under the laws of California. A requirement that a qualified CDE be a "domestic" corporation or partnership may be subject to constitutional challenge under the Commerce Clause of the United States Constitution.

2. Donations of Cash or Land for Affordable Housing Credit

Revenue Estimate

The estimated revenue impact is based on prior analysis of the same proposal (SB 981, April 16, 2001).

Orders of Magnitude Tax Years Beginning After December 31, 2001 Enactment Assumed After June 30, 2002 ($ Millions)			
Cash and property donation credit	2002-03	2003-04	2004-05
Assumptions*			
$35 million Donation	(4)	(7)	(7)
$60 million Donation	(7)	(12)	(12)
$110 million Donation	(12)	(22)	(22)

Includes $10 million in cash contributions for each level of possible real property donations.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion

The revenue impact for this bill will be determined by the value of property and the amount of cash that might be donated in any given year and the fact that tax liabilities of donors may be reduced below tentative minimum tax in applying these tax credits.

It is assumed that this proposal will generate approximately $10 million in cash contributions each year in new contributions and redirections of existing contributions. This amount is net of any other credit or deduction that the taxpayer may have otherwise claimed with respect to the qualified deduction of cash or property.

ANALYSIS

1. Investment in Qualified CDE Credit

FEDERAL/STATE LAW

General Description (See Appendix A for a detailed description)

Starting in 2001, federal law allows a new credit called the New Markets Tax Credit. That credit will enable a CDE to raise investment capital from taxpayers. The CDE will then have the capital to make loans to businesses in low-income communities or directly to low-income persons.

The New Markets Tax Credit available to the investor that holds the stock in the CDE over a seven-year period is as follows:

- a 5% credit for the first three years after the equity interest is purchased from the CDE, and
- a 6% credit for the following four years.

The maximum annual amount of qualifying equity investments eligible for the credit is capped as follows:

Calendar Year	Maximum Qualifying Equity Investment
2001	$1.0 billion
2002-2003	$1.5 billion per year
2004-2005	$2.0 billion per year
2006-2007	$3.5 billion per year

California law does not conform to the CDE credit. However, under the Personal Income Tax Law (PITL) and the Corporation Tax Law (CTL), California law allows a 20% credit for the amount of each qualified deposit into a community development financial institution (CDFI). This CDFI credit will sunset for taxable years beginning on or after January 1, 2007. See Appendix A for details of this credit.

THIS BILL

This bill would allow a credit over a seven-year period to a taxpayer for a percentage of the amount of cash a taxpayer invests in a qualified CDE. The qualified CDE must have as its primary mission serving or providing investment capital for low-income communities or low-income persons located in California. This California credit parallels the federal New Markets Tax Credit except that the CDE must be certified by the state instead of by the U.S. Secretary of the Treasury and the qualified low-income community investments must be made in California to qualify. In addition, low-income communities are defined to include only areas located in California.

The amount of state credit that may be designated as a qualified state credit by a qualified CDE may not exceed the New Market Tax Credit allowed for federal purposes. A qualified CDE is required to sell equity interests to investors within five years of the date the entity receives a federal new markets allocation. Any amount not sold within that time period is no longer eligible for the state credit.

This bill would allow the credit to reduce tax below the tentative minimum tax.

If the credit exceeds the tax for the taxable year, the excess may be carried over to reduce the tax in succeeding years, until the credit is exhausted.

IMPLEMENTATION CONSIDERATIONS

This bill would be effective January 1, 2003; however, the credit allowed by this bill would be considered retroactive to the specified operative date of January 1, 2002. Therefore, the credits claimed for 2002 by taxpayers under this provision could be construed as a gift of public funds.

The PITL credit allowed in this bill requires that the entity be certified by the state as being a qualified CDE while the CTL credit requires the certification to be done by the State Treasurer. The state agency that currently administers the economic development of low-income communities in California is the Technology Trade and Commerce Agency (TTCA). As a result, TTCA would seem to be the appropriate state certifying authority for these credits.

In addition, the bill requires the recapture of credits claimed by the taxpayer upon the occurrence of specified disqualifying events. However, the investor-taxpayer will often not know that one of these recapture events has occurred, and the department would generally be auditing the taxpayer and not the qualified CDE. The state certifying authority, in addition to the initial certification required by this bill, should also be required to monitor:

- the investments made by taxpayers in these certified entities, and
- the occurrence of disqualifying events.

The state certifying authority should then be required to at least annually notify the department of the taxpayers making qualified equity investments as well as those taxpayers impacted by a recapture event.

Also, the definition of qualified low-income community investments includes financial counseling and other services to residents of, and businesses located in, low-income communities located in this state. The use of the term "other services" without a definition could lead to disagreements between the department and the taxpayer claiming the credit. A definition of this term would enable the state certifying authority to monitor the investments made by the qualified CDE.

This bill requires the qualified CDE to designate that the investment made by the taxpayer qualifies for the credit. The CDE should also be required to report to the state certifying authority and to the department the identity of taxpayers that are making qualified equity investments in the qualified CDE. This notification would enable the taxpayer to claim the credit for the seven-year credit period, absent a recapture event, without the need for a potentially intrusive departmental audit to determine the taxpayer's eligibility for the credit.

The maximum amount that a qualified CDE can designate as qualified credits under this bill cannot exceed an amount equal to the federal New Markets Credit allocated to the qualified CDE under federal law. The state allocation must be used within five years of receiving that federal allocation. CDE should also be required to report to the state certifying authority the date and amount of the federal allocation so that the total state credit available and the time limit can be verified by the state certifying authority.

TECHNICAL CONSIDERATIONS

In Section 17052.77(a) the word “credit” was omitted. Amendment 1 would add the word “credit.”

The term "qualified low-income community investments" is defined in the bill. However, in two instances (Section 17052.77(b)(2)(B) and Section 23677(b)(2)(B)) part of the phrase was omitted. Amendments 2 and 8 are provided to resolve this issue.

The phrase "in this state" was omitted in two places in the bill (Section 17052.77(b)(4)(B) and Section 23677(b)(4)(B)). Amendments 3 and 9 are provided to resolve this issue.

In two instances (Section 17052.77(b)(5)(A)(v) and Section 23677(b)(5)(A)(v)) a cross-reference to a section in the Internal Revenue Code is incorrect. Amendments 4 and 10 are provided to resolve this issue.

In Sections 17052.77(c)(2) and 23677(c)(2), the periods for the computation of the credit overlap. Amendments 5 and 11 are provided to resolve this issue.

The bill contains two references to federal terminology rather than state terminology. Amendments 6 and 12 are provided to resolve this issue.

In two instances (Section 17052.77(f) and Section 23677(f)), the term "this subdivision" is used where the term being defined is not in "this subdivision." Amendments 7 and 13 are provided to resolve this issue.

The bill uses language that is similar but not identical to the federal New Markets Tax Credit. In some cases, these differences in language have no substantive legal effect but could nonetheless lead to taxpayer confusion. For example, the federal law identifies eligible entities as corporations and partnerships, while the bill identifies eligible entities as corporations, partnerships, and limited partnerships. While limited partnerships are required to pay an annual California tax of $800, for federal purposes and all other California tax purposes, limited partnerships are treated no differently than entities that are partnerships. However, the identification of limited partnerships as eligible entities could confuse taxpayers into concluding that other entities taxable as partnerships, such as limited liability companies, are not eligible entities.

In addition, while attempting to parallel the federal New Markets Tax Credit for qualified investments in California, the bill appears to create some unintended differences. (See “Policy Concerns” below.) To the extent consistent with the author’s intent, an alternative approach would be to provide a state credit equal to the credit authorized under federal law but limited to qualified investments in this state. Using such an approach eliminates any unintended differences between the federal and state credit, and further allows the department to clearly use any federal judicial or administrative interpretations to administer the state credit.

ARGUMENTS/POLICY CONCERNS

This bill creates a credit that is claimed by the taxpayer investor in each of seven years beginning with the year of the initial investment. One provision of the bill allows a subsequent investor to qualify for this credit if the investment was a qualified investment to the original investor. However, there are no provisions to prevent the original investor from continuing to take the credit for the full seven years and also have the subsequent investor qualify to claim the credit as well, thereby allowing two investors to simultaneously claim the credit without any infusion of new monies into the CDE.

The comparable federal credit, however, requires that the investment be held on the credit allowance date (i.e., the date the investment is initially made and on each of the six anniversary dates after the date of the initial investment) by the taxpayer in order to claim the credit. The author may wish to specify rules similar to the federal rules for the transfer of eligibility to claim this California credit, ensuring the credit would only be claimed by one investor (either the original investor or the subsequent investor). Therefore, only one investor or the other in each of the seven years beginning with the year of the initial investment would claim the credit. This is also consistent with the general policy underlying this credit that it will only be allowed with respect to the infusion of new monies into the qualified CDE.

This credit requires the qualified CDE to invest at least 85% of its aggregate gross assets in qualified low-income community investments, which means they have to be located in California. The recapture mechanisms contained in the bill insure that the 85% test will be met. However, the bill is silent about how the 85% test is to be applied in situations where the value of the CDE's investments temporarily decline to below 85%, even though more than 85% were originally invested in CA businesses. (Since these are equity investments, this is not unlikely.) As a result, it’s unclear how the value of these investments would be determined.

This bill appears to provide that a separate business or a segment of the taxpayer that generates nonbusiness income can generate this credit to be used by members of the unitary group to offset the tax due on California-sourced business income. This is in apparent conflict with unitary theory, which segregates different lines of businesses within a unitary group (and even within the same business entity) and which differentiates between business and nonbusiness income.

This credit does not specify a repeal date or limit the number of years for the carryover period. Credits typically are enacted with a repeal date to allow the Legislature to review their effectiveness. However, even if a repeal date were added, the department would be required to retain the carryover on the tax forms indefinitely because an unlimited credit carryover period is allowed. Recent credits have been enacted with a carryover period limitation since experience shows credits are typically used within eight years of being earned.

2. Donations of Cash or Land for Affordable Housing Credit

<u>FEDERAL/STATE LAW</u>

Existing state and federal laws allow deductions for charitable contributions to qualified charities and government agencies. Individuals generally can deduct amounts up to 30% of their adjusted gross income for contributions to qualified charities. Corporations can deduct amounts up to 10% of their taxable income.

Under federal law, taxpayers generally are allowed to deduct the fair market value (FMV) of property, including certain appreciated property contributed to a charitable organization, other than private foundations. However, in the case of a charitable contribution of inventory, other ordinary income property, or short-term capital gain property, the amount of the deduction is limited to the taxpayer's basis in the property.

The California PITL conforms to federal law for gifts of all types of property. Under the CTL, a taxpayer's charitable contribution deduction is limited to the taxpayer's adjusted basis in the property, regardless of the type of property donated.

Existing federal law allows a credit to an owner of a qualified low-income housing project that is constructed, rehabilitated, or acquired. The credit is claimed over a 10-year period that generally begins with the tax year the project is placed in service. The credit is claimed as part of the general business credit, which allows unused credits to be carried back one year and carried forward 20 years. The credit amount is based on the specified "applicable percentage" of the qualified basis of each qualified low-income building. The "applicable percentage" varies depending on several factors, including when the housing was placed in service and whether it was federally subsidized. A state authority, the California Tax Credit Allocation Committee (CTAC), oversees the process and allocates the credit. A qualified low-income housing project is any project for residential rental property that meets the specified requirements for low-income tenant occupancy and gross rent restrictions. The property must continually comply with all requirements throughout a 15-year compliance period or a portion of the credit must be recaptured.

Current state law conforms to the federal low-income housing credit with some modifications, as follows:

- The state credit is claimed over four years, rather than 10.
- The state credit is limited to projects located in California.
- The state credit specifies different "applicable percentages" upon which the amount of credit is computed.
- The CTAC is allowed to allocate an annual maximum of $50 million, plus unused or returned credit amounts from prior or current years. The CTAC provides listings of qualified taxpayers to the Franchise Tax Board.
- The state credit allows a corporation to assign any portion of the low-income housing credit to one or more affiliated corporations, provided the parent corporation has 100% ownership.
- The state credit may reduce the regular tax below the tentative minimum tax for purposes of the alternative minimum tax calculation.
- The state credit may be carried over until exhausted if the credit exceeds the tax.
- The state credit is not subject to recapture.

Additionally, current state law allows a credit of up to 50% of the qualified amount of costs paid or incurred for construction or rehabilitation of qualified farmworker housing in California that satisfies the requirements of the Farmworker Housing Assistance Program. The amount of the credit is allocated by the CTAC in an amount necessary to make the project feasible, not to exceed 50% of eligible costs.

Finally, California law provides for a 55% credit of the value of property donated under the Natural Heritage Preservation Tax Credit Act of 2000. Strict requirements must be met to receive this credit, including a requirement that the donated property be used as a type of wildlife refuge.

THIS BILL

This bill would provide for a credit equal to 20% of the fair market value of a qualified contribution made on or after January 1, 2002, and before January 1, 2007, to a qualified donee.

A qualified contribution would be defined as a contribution of cash or real property or a perpetual interest in real property. Real property that is to be contributed may be developed or undeveloped and must meet the following criteria:

1. The real property must be located in California.
2. At the time the real property is contributed, the taxpayer cannot be mandated by a local agency to provide affordable or low-income housing.
3. The real property must be approved for acceptance by a qualified donee.

A qualified donee would be defined as a nonprofit corporation organized under the Nonprofit Corporation Law (Division 2 of Title 1) of the Corporations Code. The principal purpose for which the donee was organized must be to enable ownership, development, or management of housing or community development projects for certain persons. Certain persons would include those who are disadvantaged, have a transitional need, have low income, or are a member of a targeted group as defined in Internal Revenue Code Section 51(d)(1) (relating to targeted groups for the work opportunity tax credit).

A qualified donee could be located in different jurisdictions of this state. The parcels of land held by the qualified donee would not be required to be contiguous.

The qualified donee would be required to provide a certificate to the taxpayer. The certificate would include the name of the taxpayer, the name and address of the qualified donee, and the property description, including the location and parcel number, if applicable. The qualified donee would also be required to sign and date the certificate. If requested by the Franchise Tax Board, the taxpayer would be required to provide a copy of the certificate to the department.

If a pass-through entity makes a qualified contribution, the fair market value of the contribution must be passed through to the owners in accordance with their interest in the pass-through entity, determined as of the date of the contribution. Pass-through entity is defined to include any estate, trust, partnership, or S corporation. If a particular partnership interest (e.g., ownership, percentage of profits or losses) is not specified, the partnership interest that would apply would be the ownership interest.

This credit would be in lieu of any other credit or deduction otherwise allowed with respect to the donation.

This bill would allow the credit to reduce regular tax below tentative minimum tax.

Any excess credit could be carried over to future tax years until exhausted.

IMPLEMENTATION CONSIDERATIONS

This bill would be effective January 1, 2003; however, the credit allowed by this bill would be considered retroactive to the specified operative date of January 1, 2002. Therefore, the credits claimed for 2002 by taxpayers under this provision could be construed as a gift of public funds.

The bill specifies that real property or a perpetual interest in real property may be a qualified contribution. The bill does not specify any other types of interests in real property that may be donated to receive a credit, such as an easement or leasehold interest. An interest in land can be sold, transferred, or otherwise disposed of in several different manners (e.g., future or remainder interest). To avoid confusion, the author may wish to specify what types of interests in the property must be donated to qualify for this credit. Additionally, the term "perpetual interest" is not defined.

The bill does not provide any conditions to ensure that the land donated could not be converted to another use by the qualified donee.

The term "fair market value" needs to be clarified. Consideration should be given to clarifying whether the fair market value refers to the fair market value of the land used for affordable housing or for the land's highest and best use.

Under the bill, the qualified donee must have been organized for the principal purpose of enabling ownership, development, or management of housing or community development for individuals who are disadvantaged, have a transitional need, have a low income, or are members of a targeted group. However, the terms “community development,” “disadvantaged,” “transitional need,” and “low income” are not defined.

The bill provides special rules for contributions by pass-through entities and defines pass-through entities to include estates and trusts. Estates and trusts are subject to state tax on net income and are not normally considered pass-through entities. The assets of a trust are “owned” by a trustee for the benefit of other persons. The assets of an estate are owned by a fiduciary during the period of administration. It is unclear which “owners” of these entities would be entitled to the credit. The author may wish to consider deleting estates and trusts from the definition of pass-through entity.

ARGUMENTS/POLICY CONCERNS

Even though this credit contains a repeal date, the department would be required to retain the carryover on the tax forms indefinitely because an unlimited credit carryover period is allowed. Recent credits have been enacted with a carryover period limitation since experience shows credits are typically used within eight years of being earned.

LEGISLATIVE STAFF CONTACT

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FRANCHISE TAX BOARD'S PROPOSED AMENDMENTS TO SB 1300
As Introduced January 18, 2002

AMENDMENT 1

On page 20, line 23, after "allowed" insert:

a credit

AMENDMENT 2

On page 21, line 18, after "low-income" insert:

community

AMENDMENT 3

On page 22, line 6, after "investment" insert:

in this state

AMENDMENT 4

On page 22, line 33, after "Section" strikeout "1397(C)(e)" and insert:

1397C(e)

AMENDMENT 5

On page 23, lines 27 & 28, strikeout "following four years after the qualified investment was initially made" and insert:

four years after the period specified in paragraph (1)

AMENDMENT 6

On page 23, line 37, strikeout "chapter" and insert:

part

AMENDMENT 7

On page 23, line 39, strikeout "subdivision" and insert:

section

AMENDMENT 8

On page 30, line 25, after "low-income" insert:

community

AMENDMENT 9

On page 31, line 12, after "investment" insert:

in this state

AMENDMENT 10

On page 31, line 39, after "Section" strikeout "1397(C)(e)" and insert:

1397C(e)

AMENDMENT 11

On page 32, lines 32 & 33, strikeout "following four years after the qualified investment was initially made" and insert:

four years after the period specified in paragraph (1)

AMENDMENT 12

On page 33, line 2, strikeout "chapter" and insert:

part

AMENDMENT 13

On page 33, line 4, strikeout "subdivision" and insert:

section

APPENDIX A

FEDERAL/STATE LAW (DETAILED DESCRIPTION)

Federal New Markets Tax Credit

For investments made on or after January 1, 2001, Public Law 106-554 includes a provision that creates a new federal tax credit (called the New Markets Tax Credit) for qualified equity investments made to acquire stock in a selected CDE. The maximum annual amount of qualifying equity investments is capped as follows:

Calendar Year	Maximum Qualifying Equity Investment
2001	$1.0 billion
2002-2003	$1.5 billion per year
2004-2005	$2.0 billion per year
2006-2007	$3.5 billion per year

The amount of the New Markets Tax Credit available to the investor that holds the investment in the CDE on the credit allowance date (either the original purchaser or a subsequent holder) is:

(1) a 5% credit for the year in which the equity interest is purchased from the CDE and the first two anniversary dates after the interest is purchased from the CDE, and
(2) a 6% credit on each anniversary date thereafter for the following four years.

The taxpayer's basis in the investment is reduced by the amount of the credit. The credit is subject to the general business credit rules.

A CDE is any domestic corporation or partnership:

(1) whose primary mission is serving or providing investment capital for low-income communities or low-income persons,
(2) that maintains accountability to residents of low-income communities by their representation on any governing board or on any advisory board of the CDE, and
(3) that the U.S. Treasury Department certifies as an eligible CDE.

In allocating the credits, the U.S. Treasury Department gives priority to entities with records of having successfully provided capital or technical assistance to disadvantaged businesses or communities. In addition, it considers entities that intend to invest substantially all of the proceeds from their investors in businesses in which persons unrelated to the CDE hold the majority of the equity interest.

If a CDE fails to sell equity interests to investors up to the amount authorized within five years of the authorization, then the remaining authorization is canceled. The U.S. Treasury Department can authorize another CDE to issue equity interests for the unused portion. No carryover of an unused authorization can be made after 2014.

A “qualified equity investment” is defined as stock or a capital interest in a partnership acquired at its original issue directly from a CDE (or through an underwriter) solely in exchange for cash. Substantially all of the cash must be used by the CDE to make “qualified low-income community investments.” Qualified low-income community investments include:

(1) capital or equity investments in, or loans to, qualified active businesses located in low-income communities,
(2) certain financial counseling and other services specified in regulations to businesses and residents in low-income communities,
(3) the purchase from another CDE of any loan made by such entity that is a qualified low-income community investment, or
(4) an equity investment in, or loans to, another CDE.

U.S. Treasury Department regulations will provide guidance with respect to the “substantially all” standard. However, a safe harbor of 85 percent is established. The stock or equity interest cannot be redeemed (or otherwise cashed out) by the CDE for at least seven years. If an entity fails to be a CDE during the seven-year period following the taxpayer’s investment, or if the equity interest is redeemed by the issuing CDE during that seven-year period, then any credits claimed with respect to the equity interest are recaptured (with interest) and no further credits are allowed.

A “low-income community” is defined as census tracts with either:

(1) poverty rates of at least 20% (based on the most recent census data), or
(2) median family income that does not exceed 80% of the greater of metropolitan area income or statewide median family income (for a non-metropolitan census tract, 80% of non-metropolitan statewide median family income).

In addition, the U.S. Treasury Secretary may designate any area within any census tract as a “low-income community”, provided that:

(1) the boundary of the area is contiguous,
(2) the area (if it were a census tract) would satisfy the poverty rate or median income requirements within the targeted area, and
(3) an inadequate access to investment capital exists in the area.

A low-income community can include a possession of the United States (and thus investments in a U.S. possession may qualify for the New Markets Tax Credit).

A “qualified active low-income community business” is defined as a business that satisfies all of the following requirements:

(1) at least 50% of the total gross income of the business is derived from the active conduct of trade or business activities in low-income communities;
(2) a substantial portion of the use of the tangible property of such business is used in low-income communities;
(3) a substantial portion of the services performed for such business by its employees is performed in low-income communities; and
(4) less than 5% of the average aggregate of unadjusted bases of the property of such business is attributable to certain financial property or to collectibles (other than collectibles held for sale to customers).

There is no requirement that employees of the business be residents of the low-income community.

Rental of substantially improved commercial real estate located in a low-income community is a qualified business, regardless of the characteristics of the commercial tenants of the property. The purchase and holding of unimproved real estate is not a qualified active business. In addition, a qualified business does not include (a) any business consisting predominantly of the development or holding of intangibles for sale or license; or (b) operation of any facility described in Internal Revenue Code sec. 144(c)(6)(B). A qualified business can include an organization that is organized on a nonprofit basis.

<u>Community Development Financial Institution Credit</u>

California law does not conform to the CDE credit. However, under the Personal Income Tax Law (PITL) and the Corporation Tax Law (CTL), California law allows a 20% credit for the amount of each "qualified deposit" into a "community development financial institution" (CDFI).

CDFIs have emerged over the last 20 years to provide opportunities for neglected communities, businesses, and individuals that lack access to traditional sources of financing. There are more than 310 CDFIs in urban, reservation-based, and rural settings in the country, and together they manage $1 billion to provide financing, investments, and extensive development services. CDFIs lend to borrowers who do not satisfy the criteria for conventional lenders.

CDFIs may be banks, credit unions, or non-regulated, non-profit institutions organized to gather private capital for community development lending or investing. Some CDFIs focus on a particular community while others lend to certain groups of people (minorities, women, low-income families, and social service providers). All CDFIs are financial intermediaries that have a common mission of community development.

Existing federal law allows a credit equal to 5% of <u>contributions</u> up to $2 million for each corporate taxpayer to community development corporations, but <u>not for deposits</u> into a CDFI. Existing state law has not conformed to the federal credit for contributions to a community development corporation.

For purposes of the 20% state credit, a qualified deposit is defined as a deposit that does not earn interest, or an equity investment, that is equal to or greater than $50,000 and is made for a minimum duration of 60 months. A CDFI is defined as a private financial institution located in California and certified by the California Organized Investment Network that has community development as its primary mission and lends in urban, rural, or reservation-based communities in California. A CDFI may include a community development bank, a community development loan fund, a community development credit union, a micro-enterprise fund, a community development corporation-based lender, and a community development venture fund.

California law provides for a recapture of the credit if the qualified deposit is reduced or withdrawn before the end of the 60-month period.

This CDFI Credit will sunset for taxable years beginning on or after January 1, 2007.